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FORTUNE

IS IBM PLAYING TOO TOUGH?



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PRODUCTS
OF THE
YEAR

DETROIT'S NEW
ASIAN CAR
STRATEGY

GOOD NEWS
AHEAD FOR
PRODUCTIVITY

FORTUNE

Corporate Performance



Robert Risko's cover illustration symbolizes IBM's new aggressiveness. See page 34.

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INVESTMENT BETS FOR 1985

Most promising, say a majority of Wall Street prophets, are stocks likely to climb if interest rates fall.

■ Will next year's stock market resemble a ripening plum or a shriveling prune? To get a feel for the coming year FORTUNE canvassed the seers at five Wall Street houses on their economic and investment outlook for 1985. As expected, the federal deficit is a big wild card in the future of stocks and bonds. Uncertain, too, is just how long the economy can continue to expand. The recovery, after all, will be in its third year. Still, Wall Street faces 1985 in a mood of moderate optimism.

None of the analysts interviewed foresees recession, or even a bear market, during 1985. The stock market, they say, should begin the year in an upbeat mood, benefiting from declining interest rates and a more manageable level of economic growth. As the months pass, the ballooning federal deficit will become more of a problem, but for now, most strategists say, let the good times roll. By most accounts the decline in interest rates has a way to go, and clients are being

urged to load up on stocks that will benefit, such as those of banks, thrifts, and insurers. Merrill Lynch, Prudential-Bache and Shearson Lehman/American Express, perhaps the most bullish on the longer-term outlook for interest rates, are also urging a healthy helping of bonds.

In a search for stocks most sensitive to interest rates, Fred Fraenkel, director of research at Pru-Bache, has come up with recommendations for some of the depressed insurers like **Continental Group** and **Travelers**. Shearson Lehman is looking to banks and thrifts. "We like **Bankers Trust**, **Manufacturers Hanover**, and **Chemical Bank** in the banking area, and **Golden West Financial** and **Home Federal of San Diego** among the thrifts," says Michael Sherman, chief stock picker at Shearson Lehman. "These stocks haven't really moved because the market doesn't yet believe that interest rates will continue coming down." Merrill Lynch

Five Prognoses

Though their projections vary, the brokerage firms below all foresee slower growth and continued low inflation. The firms' seers diverge on the question of which securities to buy.

BROKERAGE FIRM	PROJECTIONS FOR 1985				RECOMMENDED INVESTMENTS
	Real GNP Growth ¹	Inflation Rate ¹	Long-Term Interest Rate ²	Growth in Corporate Profits ¹	
Dean Witter	1.8%—2.6%	6.4%	13.5%	5.9%	Stocks likely to benefit from increased capital spending; interest-rate-sensitive stocks
Goldman Sachs	3.2%	5.6%	13%—14%	6.1%	Stocks of big-capitalization companies and low-cost producers
Merrill Lynch	3.0%	4.7%	11.0%	9.3%	Interest-rate-sensitive stocks and those likely to gain from increased capital spending; long-term bonds
Prudential-Bache	3.0%	3.8%	10.5%	4.0%	Stocks of market-share leaders in a dozen industries; utility stocks and medium-term bonds
Shearson Lehman/American Express	3.4%	3.9%	11.9%	8.5%	Stocks that could rise on renewed consumer spending; interest-rate-sensitive stocks; long-term bonds

¹Fourth quarter 1984 to fourth quarter 1985
²Fourth quarter 1985

strategist Michael Aronstein expects utility stocks and long-term bonds to continue leading the interest-sensitive parade.

Market analysts at Dean Witter are also telling clients to play an interest-rate-sensitive hand, but only for a while. The firm's chief economist, Arnold Moskowitz, expects interest rates to trend up sharply by the second quarter of next year and foresees a rate on long-term Treasury bonds surpassing 14%, up from the current rate of 11.7%, before rates settle back to 13.5% by year's end. For fleet-footed investors, John Connolly, Dean Witter's top strategist, thinks there's a quick killing to be made in Golden West and Home Federal among the thrifts.

Goldman Sachs begs to differ. Long or short term, the prophets there foresee only hand-wringing among owners of interest-sensitive stocks. They're also warning clients that bond prices will perform like lead sinkers. Not that Goldman's inflation outlook is any less sanguine than others, but the firm expects a clash between private sector and government borrowing that will push interest rates higher. Short-term investments, they say, will be the year's safest and most profitable. For those willing to venture into stocks, strategist Leon Cooperman advises a bunker portfolio full of what he calls "survival kit companies." These he describes as big-capitalization stocks of companies that are low-cost producers and are able to finance growth without trekking to the debt markets. These self-sufficient companies, he says, will be among the few to prosper in a harsh environment of slow economic growth, low inflation, and rising interest rates. Among the fittest, he says, are **Signal Companies**, an industrial conglomerate; **Cross & Trecker**, a machine tool builder; and **American Cyanamid**, a chemical producer.

Though Prudential-Bache's chief economist, Edward Yardeni, is proclaiming what he calls "a basic prosperity forecast," of low inflation and declining interest rates, the firm's stock pickers are reluctant to wager on late bloomers. "We aren't betting on any company that has not already shown some ability to increase earnings," states equity research director Fred Fraenkel. Among Fraenkel's list of favorites are **General Dynamics** and **Martin Marietta**, both primarily defense contractors; **Roadway Services**, a trucking firm; and **Santa Fe Southern Pacific**.

RESEARCH ASSOCIATE Margaret A. Elliott

le, the transportation conglomerate.

As long as the economy stays healthy, there's sure to be plenty of action next year in capital goods suppliers. These companies, which supply the technology and heavy equipment that business needs to expand, are the classic late starters in the mature stages of an economic recovery. Merrill Lynch is suggesting a generous helping of capital goods companies in the construction, machinery, and electrical equipment industries. Connolly at Dean Witter recommends loading up on technology stocks that benefit from industry's drive to boost productivity with computers. Says Connolly: "These stocks are the only place where you can find strong earnings and strong unit growth." He's filling his basket with stocks of semiconductor companies like **Texas Instruments** and computer makers like **Digital Equipment**, **Data General**, and of course **IBM**. "At ten times estimated 1985 earnings, IBM is so cheap you almost don't want to own anything else," he says.

In the third year of an economic expansion, the stocks least likely to be courted by investors are consumer stocks—autos and appliance manufacturers—whose fortunes are tied to the consumer's pocketbook. These stocks are cherished in the early stages of an economic expansion as the consumer satisfies pent-up demands, but soon taper off as individuals spend themselves out. But Michael Sherman of Shearson Lehman thinks consumers are ready to step up their buying and that the stock market will soon be consumer-driven again. He's loading up on the likes of **Ford Motor** and **Whirlpool** as the market's prospective leaders for the months ahead. If he's right, the scenario that began in August 1982 could be in for a rerun.

A European Bond Emigrates to the U.S.

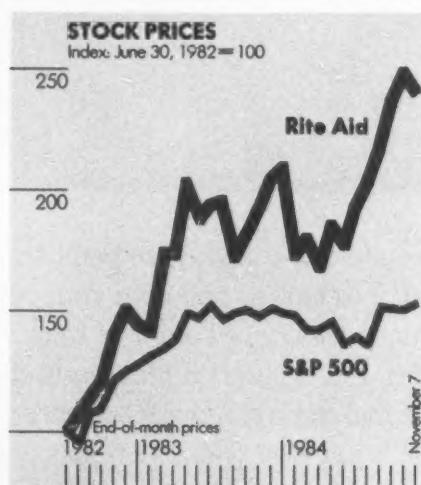
■ Tired of the same old debt securities? How about something really different that offers a chance to win big if the dollar keeps declining? In mid-November the ten-country European Economic Community served up what are believed to be the first bonds issued for public sale in the U.S. denominated in something other than U.S. dollars. The proposed \$114 million of 12-year debentures, to be co-managed by Bear Stearns, First Boston, and Morgan Stanley, will be denominated in a basket of currencies known as ECUs

(pronounced "EKUs"), short for European currency units. The currencies are weighted according to each EEC member's gross national product, with the West German deutsche mark weighing the most and the Greek drachma the least. ECUs are the world's third most widely used "currency," after the dollar and the deutsche mark, in international debt securities.

As the dollar has risen, the ECU has fallen—from \$1.12 in 1981 to a recent low of 76 cents. But many economists expect a sizable retreat of the dollar next year. If that happens and interest rates fall as well, American purchasers of ECU bonds could reap a double gain in the value of their investment.

One Drug Chain's Potent Growth Formula

■ So winning are the ways of **Rite Aid Corp.** that one of its executives ran for governor of New York three years ago partly on the strength of its record. Lewis Lehrman, a former president of the Pennsylvania-based chain of discount drugstores (fiscal 1984 sales: \$1.2 billion), lost badly to Mario Cuomo. But Rite Aid's shareholders are still enjoying a landslide of capital gains. Since 1980 the stock has risen by more than 200%, not to mention an average annual 26% hike in dividends. Though Rite Aid sells at 15 times expected 1984 earnings, security analysts



The Rite Stuff

Rite Aid's bounding growth and generous dividend payouts have propelled it far higher than the S&P 500 since mid-1982.